

competition may also be appropriate. In all events, it is unnecessary to address this issue specifically at this juncture because there is -- by any measure -- no possibility of significant local competition in the next several years.

Assuming that effective exchange competition does some day develop, the NPRM finally also seeks comment on how the Commission should modify price cap regulation at that time. NPRM, ¶ 96 (Transition Issue 2). In addition, the NPRM seeks comment on "[w]hether and how the Commission should schedule revisions in the composition of price cap baskets as local exchange access competition develops," and whether the Commission should "adopt a set of procedures that would rebalance baskets in response to specified changes in market conditions." NPRM, ¶ 97 (Transition Issue 3).

If portions of the unbundled local network truly become competitive, the Commission could properly consider streamlining price cap regulation of those BNFs and restructuring the baskets to accommodate that streamlining. AT&T's experience in this regard provides a model, albeit one based on a considerably more concrete

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percent of subscribers in a LEC's exchange area have access to such alternative providers.

and less debatable experience with competition. Upon a finding that actual competitive forces rendered regulatory price constraints superfluous, the Commission streamlined its regulation for certain of AT&T's service offerings, and thus essentially eliminated detailed price cap regulation of those services.²⁵

Similarly, if the Commission establishes that competition exists for a given BNF in the local exchange, appropriate streamlined regulation would be in order. In that circumstance, the Commission should make sure that the relevant BNF is isolated from non-competitive offerings in order to guard against cross-subsidization, by "rebalanc[ing] baskets" as noted in the NPRM (§ 97). As effective competition is determined to exist for additional BNFs, the Commission could progressively add those to the set of offerings governed by streamlined rules. In any event, however, streamlined regulation would be appropriate only in geographical locations where the existence of actual competition had been demonstrated. See, e.g., NPRM, § 95, item 8 (noting the relevance of "differences in competition in different geographic locations or regions, and differences in

²⁵ See Competition in the Interstate Interexchange Marketplace, CC Docket No. 90-132, 6 FCC Rcd. 5880 (1991) (business services); id., 8 FCC Rcd. 3668 (1993) (800 services).

demographic characteristics, such as whether services are available to all groups within a broad community or area").

In sum, with respect to the transition issues posed in the NPRM, if local exchange competition is to develop at all, it is still years away. There is no need to relax, to streamline, or to reduce price cap regulation of the LECs' interstate access services in anticipation of such competition. Quite to the contrary, any such transitional measures should await the determination that actual and effective competition is feasible and has developed in the exchange market.

II. CERTAIN MODIFICATIONS ARE REQUIRED TO MAINTAIN THE EFFICACY OF THE COMMISSION'S PRICE CAP PLAN.

Given the absence of any currently viable local exchange competition and the likelihood that the LECs' bottleneck monopolies will continue for the foreseeable future, the Commission in this proceeding should not relax any of the important customer safeguards of its current price cap regulation of those carriers, or prematurely establish any timetables for elimination of portions of the price cap mechanism. Indeed, experience with the LEC price cap plan over the past three years has disclosed several areas that require modification to assure that the Commission's objective of just reasonable and non-discriminatory access rates will be more fully achieved.

- A. Absent A Change In The Common Line Formula, Or An Adjustment To Reflect Lower Capital Costs, The LECs' Productivity Factor Should Be Increased To 5.47 Percent.

One of the most critical components of the Commission's price cap plan is the requirement that the LECs' price cap indices be adjusted annually to reflect the LECs' anticipated productivity (the "X" factor in the PCI calculation). This ensures that access rates continue to decline in relation to the GNP-PI measure of inflation.²⁶ In the LEC Price Cap Order, based on its review of two staff studies of the LECs' historic productivity, the Commission adopted an "X" factor of 3.3 percent as the minimum productivity offset for these carriers.²⁷ The NPRM (§ 44-45) notes that the LECs' average profitability has increased under price caps from the levels in prior periods, and observes that there may be "a good case" for revising the minimum and optional productivity offsets upward. The Commission therefore requests comment on whether the productivity factor should be increased.²⁸

²⁶ LEC Price Cap Order, 5 FCC Rcd. at 6796 (§ 75).

²⁷ Id. at 6799. LECs may also elect a productivity offset of 4.3 percent, and thereby retain a greater proportion of their earnings under the sharing mechanism. Id.

²⁸ NPRM, § 46. The NPRM (§ 58) also undertakes a reexamination of the Commission's current "Balanced 50/50" formula for capping common line access rates, under which changes in minutes of use per common line

The Commission's tentative proposal to increase the LECs' productivity offset is amply justified by the record of those carriers' performance under incentive regulation. Specifically, AT&T's analysis of filed Tariff Review Plan ("TRP") and ARMIS data indicates that the price capped LECs achieved an overall annual productivity of approximately 5.97 percent from January 1991 to December 1993 (the entire period for which complete data are available). This finding -- which confirms earlier information in Docket 87-313 on the LECs' historical productivity over the 1984-1990 period²⁹ -- demonstrates that the 3.3 percent productivity offset in the Commission's current formula seriously understates normal LEC productivity performance. The LECs' productivity factor should therefore be revised upward from its current level to

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are credited equally towards increased revenues for the LECs and decreased rates for interexchange carriers. Additionally, the Commission requests comment on the desirability of implementing a one-time reduction in the LECs' PCIs to reflect changes in their cost of capital. Id. As shown below, both of these revisions to the LEC price cap plan are fully warranted.

²⁹ See LEC Price Cap Order, 5 FCC Rcd. at 6797 (¶¶ 83, 86-87) (discussing studies by AT&T and other parties showing LEC productivity offsets of up to 6.9 percent, with intermediate values of 5.63 and 5.90 percent, under the Commission's original 50/50 common line formula).

reflect the higher value confirmed by actual LEC experience, less a LEC "productivity dividend" of .5 percent.

As more fully described in Appendix B, to analyze the required change in the productivity offset AT&T developed a model to determine the "X" factor in the price cap formula that would have produced an earnings level of 11.25 percent (the LECs' authorized rate of return) for the RBOCs during the several calendar price cap periods for which complete ARMIS and TRP data on those carriers are currently available.³⁰ The performance of the RBOCs represents approximately 80 percent of all price capped LECs' revenues, and thus is a valid proxy for the productivity of all LECs currently subject to price cap regulation. For example, as the Commission noted in the LEC Price Cap Order, there is "no credible evidence" that the productivity of the BOCs and the GTE Telephone Operating Companies ("GTOCs") has varied sufficiently to justify separate offsets for those carriers.³¹

³⁰ TRP and ARMIS data for all BOCs are available for the price cap periods: January 1991-June 1991; July 1991-June 1992; July 1992-June 1993; and July 1993-December 1993.

³¹ 5 FCC Rcd. at 6799. Although AT&T's analysis of price cap LECs' productivity is based on the performance of the RBOCs (for whom computer-readable data are available), AT&T will revise its analysis to include other price cap LECs if those carriers also make the

Using the procedure described above, AT&T then determined each RBOC's actual achieved productivity for all price cap periods, as well as the composite productivity for all seven RBOCs for that timeframe. As shown in Appendix B (Table B.1), this analysis demonstrates that, for the three year period studied, individual RBOCs achieved productivity factors from as high as 7.61 percent to as low as 3.48 percent. In the aggregate, the RBOCs' performance over the entire period reflects productivity of 5.97 percent.³² The Commission

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required financial data available in computer-readable form, consolidated over each holding company's group of study areas.

³² The validity of the AT&T model's result is confirmed by calculating the relationship between the dollar value of one percentage point of rate of return for the LEC holding companies and the dollar value of a percentage point change in those holding companies' gross revenues where the latter change corresponds approximately to a one percentage point change in the productivity offset. This simplified analysis was used by the Commission in its earlier price cap proceedings to verify the reasonableness of results generated by other models. See Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd. 2873, 3213-14 (1989) (¶ 705).

As shown in Appendix C, this analysis indicates that each percentage point of LEC earnings above the authorized level (11.25 percent) corresponds to a LEC productivity factor of approximately 2.23 percentage points above the X factor in the current price cap formula (3.3 percent). Given that price capped LECs' overall earnings for the January 1991-December 1993 period averaged approximately 12.89 percent, the validation methodology indicates that these carriers achieved a productivity of 6.96 percent (the sum of

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should therefore modify its current price cap formula to establish the productivity offset at this level, less a .5 percent "productivity dividend" for exceeding the Commission's 3.3 percent goal, to encourage LECs to continue to perform efficiently.³³

As Appendix B also demonstrates, a somewhat smaller revision in the productivity offset (approximately .8 percent less) will be required if the Commission substitutes a "per line" formula for the "Balanced 50/50" formula for capping the common line basket, as suggested in the NPRM (¶ 58-59). AT&T agrees that elimination of the 50/50 formula is fully justified, because that mechanism has failed to achieve its objective of encouraging growth in common line usage. The Commission should instead adopt a "per line" formula,

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3.3 percent and 3.66 percent). This result may vary slightly from the findings of AT&T's direct model showing a LEC productivity factor of 5.97 percent. But such variations are likely the result of complicating factors related to the common line plan, taxes, and below-cap pricing by the LECs.

³³ Establishing the LECs' productivity offset (less the productivity dividend) at 5.47 percent is, if anything, a conservative measure, because that offset is based on an earnings level of 11.25 percent. As shown below in Point II.B, due to the LECs' lower cost of capital, their reference earnings level should be reduced to less than 10 percent.

as AT&T originally urged in Docket 87-313, as the means of capping non-traffic sensitive access charges.³⁴

The LEC Price Cap Order established the balanced formula on the basis that this mechanism would "encourage[] LECs to upgrade their networks in ways that stimulate growth in demand. . . ." ³⁵ Analysis of the LECs' operations over the past three years demonstrates that these hoped-for results have not been achieved. During the period June 1984 to December 1989, before the adoption of LEC price cap regulation, common line minute growth per line (net of demand stimulation) averaged 4.56 percent annually.³⁶ By contrast, since the adoption of price cap regulation average annual common line minute growth per line has been only 3.24 percent.³⁷ Thus, contrary to the Commission's original expectation, growth in common line usage has not been demonstrably stimulated

³⁴ However, even capping on a per line basis is a "second best" alternative for implementing improved regulation of common line charges. As AT&T has repeatedly urged, end user charges that fully reflect costs are the most economically rational and cost causative method for non-traffic sensitive cost recovery.

³⁵ 5 FCC Rcd. at 6795.

³⁶ See LEC Price Cap Order, 5 FCC Rcd. at 6885 et seq.

³⁷ These growth data are derived from the LECs' filed TRP data for April 1991, April 1992, April 1993 and April 1994.

during the period the Balanced 50/50 formula has been in effect.

In lieu of the Balanced 50/50 formula, the Commission should revise its incentive regulation plan to cap common lines charges on a per-line basis. As the NPRM (§ 57), recognizes, a per-line cap creates appropriate incentives for LECs to increase their productivity (and hence reduce their costs) because this capping mechanism automatically reduces per minute common line charges as demand increases.³⁸ Thus, compared to the Balanced 50/50 formula, a per-line cap will more effectively promote just and reasonable access rates. The Commission should therefore adopt the NPRM's tentative proposal and revise the common line formula to reflect a per-line cap on non-traffic sensitive access rates.³⁹

³⁸ This result occurs because the per-line capping mechanism correctly tracks the number of common lines that generate common line expense. AT&T has previously described the benefits of a per line cap in Docket 87-313. See AT&T Comments filed June 19, 1989 on Second Further NPRM, p. 6; AT&T Comments filed May 7, 1990 on Supplemental NPRM, p. 16.

³⁹ Some LECs have also recently suggested that their traffic sensitive and trunking baskets may also be partially non-traffic sensitive. See, e.g., NYNEX Transition Plan to Preserve Universal Service in a Competitive Environment, filed December 15, 1993. The Commission should therefore also consider partly capping those baskets on a per-line basis.

B. The Sharing And Lower Formula Adjustment Mechanisms Should Be Modified To Further Protect Access Ratepayers.

To ensure that the LECs and their access customers fairly share in the results of the LECs' productivity changes, the LEC Price Cap Order established an annual mechanism to trigger sharing of the LECs' earnings (or, conversely, to increase their caps temporarily) based on their realized rate of return in the preceding year. The NPRM (¶¶ 52-54) notes that many of the LECs have questioned the continued need for this adjustment mechanism, and seeks comment on whether it should be retained. Moreover, if the sharing mechanism is retained, the Commission requests comment on whether the rate of return thresholds should be realigned to reflect changes in the LECs' cost of capital since the adoption of LEC price caps.

The sharing mechanism, coupled with an appropriate increase in the productivity offset as described in Part II.A, is an integral component of the Commission's incentive regulation plan to assure reasonable access rates. In its orders in Docket 87-313, the Commission correctly rejected the LECs' claims that the sharing mechanism is unnecessary. The Commission should do so again here. In fact, as shown below, that mechanism should be further modified to account for the marked reduction in the cost of capital within the past

few years. There is no justification, however, for retaining the lower formula adjustment portion of the Commission's adjustment mechanism. Experience under price caps has shown that the LECs require no protection against unduly low earnings, and LECs have been given opportunities they do not need to raise their caps under the lower adjustment formula.

1. A One-Time Reduction Should Be Implemented In The LECs' Rate Levels.

The thresholds in the Commission's sharing mechanism reflect the LECs' authorized rate of return, including the cost of capital, at the inception of price cap regulation. However, as the NPRM (§ 44) correctly observes, since that time interest rates have decreased dramatically, permitting these carriers to raise capital at a far lower cost than the 11.25 percent prescribed in 1990 as the LECs' authorized rate of return. In light of this development, the sharing mechanism, standing alone, is no longer sufficient to assure that access ratepayers share in the LECs' productivity gains. To provide that assurance, the Commission should direct the LECs both to implement a one-time reduction in their price caps, and to reduce the thresholds triggering the sharing mechanism to reflect the change in the cost of capital since the adoption of price caps.

AT&T has performed a discounted cash flow analysis of the LECs' cost of capital to measure the change in these expenses since 1990.⁴⁰ That study, attached as Appendix D, shows that the LECs' cost of capital has averaged no higher than 9.93 percent over the period 1991-93 -- some 132 basis points lower than those carriers' current reference rate of return. Several sources independently confirm the results of AT&T's discounted cash flow analysis.

Specifically, a report examining the LECs' newly authorized intrastate returns has found that in 1993, the required return on equity for those carriers had declined by 110 basis points since 1990.⁴¹ The cost of embedded LEC debt has declined by approximately 140 basis points over the same period.⁴² Based on an average RBOC debt ratio of 47.5 percent, the LECs' average weighted cost of capital during this time has declined by about 124 basis points.

⁴⁰ The data underlying the cost of capital figures computed here are from the RBOCs. Part 65 of the Commission's Rules provides that the prescribed rate of return for all LECs will be determined based on data supplied by the RBOCs.

⁴¹ Regulatory Research Associates, Inc., Regulatory Focus, April 13, 1994. Moreover, in the two represcriptions that have taken place in the first quarter of 1994, the state-determined return on equity has been 53 basis points below the 1993 average.

⁴² See Appendix D, Table D.3.

This reduction in the LECs' capital costs also mirrors the trend in the economy as a whole; during this period, economy-wide interest rates have fallen by 220 basis points.⁴³ Viewed together with the results of AT&T's discounted cash flow analysis, these data provide compelling evidence that the LECs' actual cost of capital is currently at least 132 basis points lower than the rate used by the Commission to initialize the LECs' price caps in 1990.⁴⁴

In light of this marked, longstanding change in the LECs' cost of capital, the Commission should require the LECs to reduce their current PCIs to reflect the portion of this lower cost that has not been reflected in the GNP-PI. AT&T estimates that the required change in the PCIs will reduce the LECs' current caps by a total of

⁴³ Six month moving average of Aa Public Utility Bonds: September 1990 versus April 1994.

⁴⁴ The LECs' own comments filed with the Commission in other proceedings have explicitly contemplated that those carriers' authorized earnings levels would be revised periodically to reflect changes in economy-wide interest rates. Specifically, in CC Docket No. 92-133 (Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Prescription and Enforcement Processes) numerous LECs supported an automatic trigger for the rate of return prescription process if the 6 month moving average of Aa utility bond yields changed by more than 150 basis points from the value existing prior to the previous prescription. This triggering threshold proposed by the LECs was reached in March 1993 and has been maintained to the present.

\$322 million.⁴⁵ This will at least assure that the LECs' maximum rates are set relative to their actual cost of capital in the future.⁴⁶

Additionally, because the current LEC minimum sharing thresholds of 12.25 and 16.25 percent were initially set at 100 and 500 basis points, respectively, above the then-authorized return of 11.25 percent, each of those thresholds should be reduced by 132 basis points to maintain the same relationship relative to the current LEC cost of capital of 9.93 percent.⁴⁷

⁴⁵ Appendix E demonstrates that because the LECs are twice as capital intensive as the average firm, the decline in the economy-wide cost of capital that is captured in the GNP-PI is only half as large as the actual capital cost reduction that the LECs have enjoyed. As also shown in Appendix E, adjusting the LECs' revenues to account for the capital cost reduction that is unreflected in the GNP-PI would reduce those carriers' revenue requirements by \$322 million.

⁴⁶ Adjusting their PCIs to remove the portion of the LECs' prices attributable to an overstated cost of capital would also require an appropriate adjustment to be made in the calculation of the LECs' historical productivity for the 1991-1993 period, to remove the excess "productivity" that was the result of those carriers' lower cost of capital. AT&T calculates that if these excess revenues of \$322 million are removed from the LECs' productivity calculations, the historically achieved productivity level would be .55 percent less than the value of 5.97 percent computed when full LEC revenues are included. See Part II.A, supra.

⁴⁷ As shown in Part II.B.2, the lower formula adjustment mechanism is superfluous and should be eliminated entirely to avoid manipulation by the LECs. Should the Commission nevertheless decide to retain that mechanism it should at least reduce the threshold for

2. The Current Lower Formula Adjustment Mechanism Should Be Eliminated.

In adopting the LEC price cap plan, the Commission envisioned that various conditions could lead those carriers to experience unusually low earnings levels which, over a prolonged period, might seriously impair their ability to attract capital and to provide adequate service. Specifically, the LEC Price Cap Order cited as the possible causes of such prolonged underearnings "an error in the productivity factor, the application of an industry-wide factor to a particular LEC, or unforeseen circumstances in a particular area of the country" which are beyond the LEC's control, "such as local or regional recessions."⁴⁸

Therefore, as a precautionary measure the Commission provided that a LEC whose earnings for the base period fall below a "lower adjustment mark" of 10.25 percent may adjust its PCIs upward to retarget rates in the subsequent price cap year to earn at the

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that adjustment to 8.93 percent (i.e., by 132 basis points) to reflect the LECs' lower cost of capital compared to when the adjustment mechanism was first established.

⁴⁸ 5 FCC Rcd. at 6804 (¶ 147).

lower mark.⁴⁹ This adjustment mechanism for underearnings was not intended, however, to guarantee the future profitability of a LEC or to compensate that carrier for its past shortfalls. Rather, its sole purpose was to ensure, prospectively, that a LEC will be able "to raise the capital necessary to provide new services that its local customers expect" and "to maintain existing levels of service."⁵⁰

Actual experience under incentive regulation shows that the Commission's initial concern that the price cap plan could impose undue hardship on any particular LEC was unfounded. Far from being too stringent, as shown above in Part II.A, the current productivity offset is seriously understated. Moreover, no evidence has been presented that an average industry-wide LEC productivity factor is inapposite for any of the individual carriers subject to price cap regulation. Finally, no LEC has credibly claimed (much less proven) that localized economic downturns or similar conditions

⁴⁹ Id.; 47 C.F.R. § 61.45(d)(1)(vii). These PCI adjustments must be reversed at the end of one year, so that the LEC does not continue to benefit from the adjustment mechanism after its earnings have risen to the lower mark. See LEC Price Cap Reconsideration Order, 6 FCC Rcd. at 2691.

⁵⁰ Id. at 6804.

have impeded its ability to achieve sufficient earnings to provide satisfactory service.

Instead, the lower formula adjustment mechanism has been principally used by the LECs to recoup one-time accounting charges to earnings from access ratepayers. For example, in 1991 NYNEX adopted a three year program to reduce its workforce through retirements and involuntary separations from service as a means of increasing its efficiency. NYNEX included the accrued expenses for this "downsizing" in the calculation of its 1991 interstate rate of return, resulting in reported earnings below the 10.25 percent "lower mark" triggering a lower formula adjustment. In its 1992 annual access tariff filing, NYNEX then sought an increase of approximately \$69 million in its PCI levels based on that one-time charge against earnings.

AT&T opposed NYNEX's lower formula adjustment based on that charge, on the ground that it required access ratepayers to compensate NYNEX for the efficiency gains resulting from the downsizing program.⁵¹ However, the Commission found that the lower formula adjustment mechanism prescribed in the LEC Price Cap Order allows no

⁵¹ AT&T did not challenge the implications of this charge under other price cap rules.

distinction as to the reasons for a LEC's underearnings, and permitted NYNEX's tariffs to take effect.⁵²

As this episode illustrates, the lower formula adjustment mechanism has in practice become a device for relieving the LECs of business risk -- and thus blunts the LECs' incentive to achieve higher productivity. This result is clearly contrary to the Commission's objectives in adopting price cap regulation of those carriers. The Commission should therefore conclude that the lower formula adjustment mechanism is no longer required to protect the LECs from prolonged, service-affecting earnings deterioration, and should eliminate this treatment for carriers now subject to the price cap plan.⁵³ Should any of these carriers be confronted in

⁵² 1992 Annual Access Tariff Filings, 7 FCC Rcd. 4731, 4735 (1992). For this same reason, the Commission found it was required to deny the claim raised by some intervenors that permitting a lower formula adjustment based on actions within the LECs' control affecting those carriers' earnings, would subvert the limitations imposed elsewhere in the LEC Price Cap Order on the types of cost changes that may qualify for exogenous treatment (and thereby allow a change in the PCI).

⁵³ If necessary, to provide an incentive for additional LECs to adopt price cap regulation in the future, the adjustment mechanism may be retained for a limited transitional period (not to exceed four years) for carriers newly electing price cap regulation. Such limited retention of the adjustment mechanism will assure that these LECs will not be immediately disadvantaged by a decision to elect incentive regulation.

the future with an extraordinary event that significantly reduces the LEC's earnings over time (for example, a localized economic recession) that situation can, if warranted, be adequately addressed by allowing a temporary exogenous change in the carrier's price cap.

C. Measured Improvements Should Be Implemented In The Basket And Band Structures To Assure Reasonable, Nondiscriminatory Access Rates.

The LEC price cap plan was intended to create economic incentives for the LECs to improve their productivity and to offer new services -- incentives that approximate those that would exist in a competitive local exchange market. The Commission created the four LEC service baskets (common line, traffic sensitive, trunking and interexchange services) and the service categories and bands within the baskets to "replicate the effect of competition" in the exchange market.⁵⁴ The NPRM requests comment on whether any changes should be made to the price cap rules related to baskets and bands (§ 42) and new services (§ 83). Given the lack of competition in the exchange market, the price cap plan and the basket and band structure will continue to be necessary for the foreseeable future.

⁵⁴ NPRM, § 38.

Before adopting the LEC price cap plan, the Commission considered a wide variety of basket structures, and after careful deliberation, adopted the four service baskets with their related categories and subcategories.⁵⁵ Only recently, and again following extensive analysis and deliberations, has the Commission made modifications to the baskets and categories.⁵⁶ Because of the nature of the composition of the baskets, the Commission intended the carrier to have "little incentive to shift costs between baskets, because changes in prices within one basket do not affect prices in the others. Within the basket, however, the carrier has the incentive to change prices, in order to increase efficiency and maximize its profits."⁵⁷ The Commission's decision represents a balance of competing considerations (incentives for the LECs and protections for consumers) and nothing has occurred since the Commission's most recent revisions to these baskets in the Second Transport

⁵⁵ See, e.g., LEC Price Cap Order, 5 FCC Rcd. at 6810-11.

⁵⁶ See Expanded Interconnection Order, *supra* (ordering category expansion in the special access basket to accommodate zone density pricing); Transport Rate Structure and Pricing, 9 FCC Rcd. 615, 622-27 (1994) ("Second Transport Order") (realigning the traffic sensitive and special access baskets).

⁵⁷ NPRM, ¶ 38.

Order less than four months ago that suggests this balance should be disturbed.

Although AT&T agrees that it may be appropriate for LEC price cap regulation to be streamlined if competition develops, there simply is no competition in the local exchange market today, and not likely to be any effective competition at any time soon.⁵⁸ Thus, there can be no serious claim that market forces can somehow replace the consumer protections provided by existing price cap controls. In light of the lack of competition in the local exchange market, the basic structure of LEC service baskets should be retained to preclude excessive rates and cross-subsidies.⁵⁹

As one measured change to the LEC price cap plan's service baskets, the Commission should ensure that the LECs are consistent when assigning services to baskets, service categories and subcategories.⁶⁰ For

⁵⁸ See Part I, supra.

⁵⁹ Should competitive conditions change in the future, some alterations in the basket and band structure may be warranted. For example, many LECs have recently filed Section 214 applications to provide video dial tone ("VDT") services. Because of the potential competitive nature of these offerings, it may be appropriate for a separate VDT basket to be established under the LEC price cap plan.

⁶⁰ Additionally, because experience demonstrates that the LECs have inconsistently interpreted Section 61.45(c) of the rules with respect to the inclusion of new services in base period demand, the Commission should

example, because of the lack of a specific rule mandating the classification of LEC operator services, price cap LECs have accorded those services widely disparate treatment. Some carriers have incorporated those rate elements in their interexchange baskets,⁶¹ while others have included these services in the information category of the traffic sensitive basket,⁶² and still others have assigned them to the local transport category in that basket.⁶³ As a result, the Commission last year initiated a proposed rulemaking in which it concluded that the current treatment provides the LECs an unwarranted ability to raise rates for these operator services, relative to those carriers' other traffic sensitive or interexchange rates.⁶⁴

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clarify that rule's definition of the "R" factor (base period demand) in the LEC price cap equation.

⁶¹ Bell Atlantic, BellSouth, NYNEX (line status verification service), Pacific Bell and Southwestern Bell.

⁶² GTE, SNET (line status verification service) and United.

⁶³ Ameritech (operator transfer service), NYNEX (operator transfer service), and SNET (operator transfer service).

⁶⁴ See Treatment of Operator Services Under Price Cap Regulation, 8 FCC Rcd. 3655 (1993) (¶ 4). The LECs' ability to adjust their access rates in this manner is illustrated by NYNEX's 1992 annual access tariff filing. There, NYNEX proposed increases of up to 47 percent in its rates for line status verification

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Similarly, when the Commission required the LECs to implement a data base system of access for 800 service, it adopted rate structure and pricing rules for 800 data base access services.⁶⁵ These rules included a requirement that price cap LECs treat basic 800 data base access service separately from vertical features, and that a separate sub-index be employed for vertical features to avoid potentially anticompetitive pricing.⁶⁶ The Commission is now investigating the LEC 800 data base access tariffs, and notwithstanding the explicit requirements it adopted prohibiting the bundling of vertical features with basic services, one of the issues the Commission is investigating is whether certain LEC tariffs contain impermissibly bundled rate elements.⁶⁷

These LEC actions demonstrate the critical need for the Commission to continue carefully monitoring LEC assignments of services to baskets and subcategories to

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access service which that carrier had included in the interexchange basket, and reductions of up to 50 percent for the "corridor" services NYNEX offers directly to end users in competition with IXC's.

⁶⁵ Provision of Access for 800 Service, 8 FCC Rcd. 907 (1993).

⁶⁶ Id. at 908, 912.

⁶⁷ 800 Data Base Access Tariffs and the 800 Service Management System Tariff, 8 FCC Rcd. 5132, 5133 (1993).

confirm that they are done correctly and consistently by all LECs to avoid future strategic or anticompetitive pricing.

Additionally, although AT&T generally supports the additional pricing flexibility provided to the LECs by the Commission's decision to allow zone density pricing,⁶⁸ it is imperative that appropriate limits be placed on further upward pricing flexibility and geographical rate deaveraging by the LECs. First, zone density pricing differentials should be permitted for additional access services only upon a clear and convincing showing by the LECs of geographic cost differences for the service in question. This is necessary to ensure that improper rate differentials do not arise, with lower rates in areas where competition may be struggling to emerge, financed by non-cost based increases in other service areas.⁶⁹

⁶⁸ Expanded Interconnection With Local Telephone Company Facilities, 7 FCC Rcd. 7369, 7451-58 (1992), recon. 8 FCC Rcd. 127 (1992), further recon. 8 FCC Rcd. 7341 (1993), peta. for recon. pending, appeal pending sub nom. Bell Atlantic Corporation v. FCC, No. 92-1619 (D.C. Cir., filed November 25, 1992); Expanded Interconnection With Local Telephone Company Facilities, 8 FCC Rcd. 7374 (1993).

⁶⁹ The Commission should also carefully monitor the zone density pricing permitted to date, to assure that these rate differentials remain cost-based.